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Powell and Section 2036: Our Reply

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We very much appreciate the commentary by Messrs. Angkatavanich, Dougherty and Fischer as well as the commentary by Professor Jensen.

Angkatavanich/Dougherty/Fischer agree with our principal argument: that section 2036 was not designed to apply to family limited partnerships. They also agree that the *Powell* court's use of its "illusory" standard is inconsistent with the majority in *Byrum*. Finally, they agree that the application of section 2043 in the partnership context is potentially problematic and should therefore be rejected in favor of an approach that would simply disregard the partnership where its assets are subject to section 2036 inclusion – an approach favored by the concurring opinion in *Powell*.

On the other hand, Professor Jensen disagrees with us in two respects. First, he maintains that we misread *Byrum*. His starting premise is that fiduciary duties applicable in the business-entity context are equivalent to the fiduciary duties applicable to a trustee for purposes of section 2036(a)(2). He reads *Byrum* as having implicitly embraced this equivalency, claiming that neither the majority nor the dissent addressed the difference between fiduciary duty in these two contexts. Second, he argues that section 2043 should apply in the family limited partnership context – reasoning that, although the section is flawed, there is no justification for treating such partnerships differently from any other exchange in which the decedent had received consideration. We offer a brief reply.

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SECTION 2036(A)(2) AND FIDUCIARY-DUTY CONSTRAINTS

We disagree with Professor Jensen's claim that neither the majority nor the dissent in *Byrum* addressed the difference between a trustee's fiduciary duty and the fiduciary duty owed in the context of a business entity. As we noted, Justice White, in his dissent, cited *O'Malley* for the proposition that a trustee's general fiduciary duty does not negate inclusion under section 2036(a)(2).[1] He argued that, based on *O'Malley*, general corporate fiduciary duties should likewise not negate inclusion in *Byrum's* gross estate.[2] He maintained that the majority's holding in *Byrum* – that general corporate fiduciary duty does negate inclusion – was "incompatible" with the Court's treatment of a trustee's general fiduciary duty in *O'Malley*.[3]

The majority replied that, in *O'Malley*, the decedent had explicitly reserved the right in the trust instrument to make decisions about distributions for the benefit of his various family members, thus in effect carving out a space in which he had the right to exercise discretion based on personal or familial considerations.[4] In contrast, in *Byrum*, there was no such carve-out. As a result, the majority held that general corporate fiduciary duties, which would preclude the exercise of discretion on the basis of personal or non-business considerations, were a sufficient constraint to negate estate tax inclusion.[5]

Professor Jensen's reading of *Byrum* is therefore incorrect as a descriptive matter. Indeed, the *Powell* court itself accepts the *Byrum* principle that a general corporate fiduciary duty can be a sufficient constraint to negate inclusion. Its departure from *Byrum*, in our view, is its reading of the majority as having established a standard, rather than a rule, under which a fiduciary-duty constraint can be disregarded if found in the context of the particular facts to be "illusory." We wish to emphasize that, to the extent Professor Jensen's comment can be read as

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1 United States v. Byrum, 408 U.S. 125, 157 (1972) (White J., dissenting) (rejecting the majority position that a settlor seeking tax exemption may keep the power of income allocation by rendering the trust dependent on an income flow he controls because the general fiduciary obligations of a director are sufficient to eliminate the power to designate within the meaning of section 2036(a)(2)).

2 *Id.*

3 *Id.*

4 As Justice White intimated, even where the decedent had such discretion in his or her capacity as trustee, estate-tax inclusion would nonetheless be inappropriate if the decedent's discretion was circumscribed by an ascertainable standard contained in the instrument. *Id.* at 156-57. *See also* Rev. Rul. 73-143, 1973-1 C.B. 407.

5 The majority explains that, in *O'Malley*, "the settlor had reserved a legal right, set forth in the trust instrument . . ." *Byrum*, 408 U.S. at 136. It then goes on to distinguish *O'Malley* on the ground that "Byrum reserved no such 'right' in the trust instrument or otherwise." *Id.*

espousing a normative view about the equivalence between a trustee's fiduciary duty and a business-entity fiduciary duty for estate tax purposes, he raises an issue we did not address. Our focus was on the framework *Byrum* established and its misapplication in *Powell.* But we do emphatically disagree with his descriptive claim about *Byrum.*[6]

Section 2043: Application in the Partnership Context

Professor Jensen acknowledges that the mechanics of section 2043 are flawed, but argues that there is no justification for treating partnerships differently from other exchanges. All exchanges in which the decedent had received consideration should, he argues, be subjected to the same flawed treatment.

Our principal point was that the courts erred in establishing section 2036 as the mechanism for dealing with abusive partnerships. We argued that it is not a very good fit and that the courts should have instead established a threshold partnership-recognition test, under which abusive partnerships lacking a non-tax purpose would be ignored for estate tax purposes — analogous to the treatment of such partnerships for income tax purposes. Under our approach, section 2036 and its adjunct rule in section 2043 would be inapplicable. Instead, the partnership's assets would be included in the gross estate, and the decedent's interest in the partnership would be ignored (i.e., not included in the gross estate under section 2033). This would, of course, avoid the problematic outcome that flows from the flawed mechanics of section 2043 in the case where the assets conveyed to the partnership increase or decrease in value between the date of partnership formation and the date of death.

In short, we made reference to the difficulties with the application of section 2043 in the partnership setting to illustrate our principal point: that section 2036 is not a good fit. We do, however, believe that, if section 2036 is to remain the weapon of choice in combating abusive part-

6 It is worth noting that, after setting forth its enforceable-right and fiduciary-duty framework, the *Byrum* majority did also make reference to the decedent's inability to control trust distributions once the dividend income reached the hands of the trustee. *Id.* at 143. While one might question the effect of this reference, we do not believe it would make sense to read it as negating or undoing the framework the majority carefully established in the balance of its opinion. Indeed, the dissent's understanding of the majority is consistent with our view. The same is true of the *Powell* court: It embraces the framework but concludes, in applying it, that the fiduciary-duty constraints at work in *Powell* were "illusory" and should therefore be ignored. Estate of Powell v. Comm'r, 148 T.C. No. 18, 2017 WL 2211398, at *7 (T.C. May 18, 2017). And, significantly, the framework is consistent with the well-ingrained ascertainable-standard rule, see *Byrum,* 408 U.S. at 156-57, under which a standard contained in the instrument limiting the trustee's discretion is treated as a constraint that precludes the decedent from being treated as having had a legally enforceable right. *Id.* at 136-37.

nerships, it should be applied in the fashion we suggested: including the partnership assets in the gross estate and disregarding the partnership interest – which is the approach taken in the concurring opinion in *Powell.*

Unlike Professor Jensen, we do see a difference in the application of section 2043 to partnerships. In the typical case involving section 2043, there is a tracing problem that can perhaps justify the section's failure to take into account post-exchange fluctuation in value. To illustrate, assume the decedent transferred property having a value of $100,000 in exchange for an asset having a value at the time of the exchange of $50,000. The section permits an offset in determining the amount of inclusion equal to the value of at the time of the exchange of the asset received, i.e., $50,000, even if the asset had appreciated in value between the time it was received and the time of death. Inasmuch as the asset the decedent transferred in the exchange is included in the gross estate under section 2036 based on its date-of-death value, parallel treatment would require that the offset under section 2043 also be based on the date-of-death value of the asset the decedent received. But because of the possibility that the decedent may not own the asset at the time of death and the resulting tracing problems, the section provides an offset equal to the value of the received asset at the time of the exchange.

In the partnership context, however, the tracing problem is ordinarily not significant. In the typical partnership case where the partnership's assets are included in the gross estate under section 2036, the decedent still owns the property received in the exchange, the partnership interest, at the time of death. As a result, there is no tracing problem. It would therefore make sense, as we suggested, to simply ignore the partnership — and not apply a flawed provision (section 2043) that is driven by a tracing problem that does not exist in this setting.

While it might be argued that, to the extent the application of section 2043 produces "double inclusion" in the partnership setting, it provides a salutary deterrent for taxpayers contemplating the use of an abusive partnership, the section also fails to produce the correct outcome where the value of the partnership assets declines. In the example we provided, a decline in value produced a discount on account of the application of section 2043 even though, as we indicated, the partnership was formed for the sole purpose of achieving an estate-tax reduction.

Professor Jensen does not this address this example. We believe that the outcome in the declining-value example is unacceptable. We similarly believe, but with less conviction, that the outcome in the increasing-value example should be rejected. Regardless of how one may come out in the latter context, we do not agree with Professor Jensen's argument that the flawed mechanics of section 2043 should apply in the partnership setting because it is tolerated in non-partnership contexts.